How to Keep CEO Pay in Check

The New Republic: A Journal of Politics and the Arts
Posted by Clay Risen
September 24, 2008

You know things are seriously bad when even the Bush White House is open to negotiation. This afternoon brings news that it will accept a Democratic proposal, put forth by Senator Chris Dodd, on the issue of executive compensation. It includes a provision to prevent executives of bailed-out companies from getting severance packages and any "incentives for executives to take risks that the Secretary deems to be inappropriate or excessive." Executives would also have to give back bonuses based on earnings later found to be inaccurate, a so-called "claw-back provision."

Rules restricting executive compensation have been a hot topic for several years in Washington, and as a symbolic step, they're a no-brainer. Not all executives get paid exorbitant salaries, but a study by **Harvard's Lucian Bebchuk** and Cornell's Yaniv Grinstein found that total compensation for the five top-paid execs at all public companies ate up 10 percent of corporate earnings--and that was between 2001 and 2003. Imagine where they are today. Such skewed numbers fly in the face of those who claim that executive pay is still just a drop in the bucket of corporate profits. Instead, not only does it sap away a significant amount of company income, but inasmuch as the packages are tied to performance, they incentivize executives to take outsized short-term risks, then bail out. (Of course, they aren't really tied to performance, since most top executives have clauses that establish high floors on how much they can walk away with, regardless of their firm's health.)

But there is a right and a wrong way to address the issue of executive compensation, and the Dodd plan is the wrong way. For one, it seems overly punitive to ban all severance packages for executives at bailed-out firms. Sure, it would punish those who played fast and loose with their firms' money, but it would also punish conscientious executives who decide the bailout is the best way to protect their shareholders. Plus, it would create incentives to stay away from the plan even if it's in the best interests of the firm. But the biggest concern is the x-factor at the heart of all regulatory proposals: When it comes to huge sums of money, regulations are just puzzles for clever accountants to solve. It's the same dilemma faced by campaign-finance reformers. If you say money can't move from A to B via channel X, pretty soon it will be moving via channel Y--a channel you didn't even know existed.

There is a better path to regulating executive pay: shareholders. Right now shareholders have very little say in things like executive compensation, and almost no way to punish executives who walk away with millions after ruining their investments. The SEC, Congress, and investor advocates have long sought ways to open up corporate voting structures to give shareholders more say, and one of the silver linings of the current crisis is that it creates a political opening for just such a proposal.

This is a much bigger idea than the very focused limits sought by the Dodd plan. But the risk is that this ultimately symbolic populist proposal will make it harder for future, comprehensive changes to come to a vote--the risk of a "been there, done that" attitude among lawmakers. Congressional Democrats intent on corporate reform need to focus on negotiating the Paulson plan, but they also need to have one eye on the long view, toward next year, when they will almost certainly have a larger majority in Congress and likely (for now, at least) a fellow Democrat in the White House. Corporate governance reform can, and should, wait until then.